No. 21081

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

HENRY ROY,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

On Appeal From the Judgment of the District Court of the United States, Southern District of California, Central Division.

APPELLANT'S REPLY BRIEF.

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APPELLANT'S REPLY BRIEF.

Introduction.

The argument which follows is entirely in reply to arguments advanced by appellee in its brief. An observation is appropriate before replying to Appellee's Brief to note what appellee did *not* dispute therein.

The Government has concerned itself solely with the concept of *adequacy* of books and records when establishing justification for use of circumstantial evidence in a criminal tax case — appellee has not responded to appellant's contention that the investigating agents, and the courts, should first look to the *accuracy* of the taxpayer's books and records before blindly resorting to the use of such evidence. Such a response is understandable as the appellee cannot dispute the major points upon which the appellant relies. The taxpayer

apparently maintained accurate books and records (or at least the Government could not prove that the records were inaccurate) and the investigating agents never requested or examined the available records.

The appellee also claims that the appellant was not harmed by use of the bank deposits method, or in the alternative, that this harm was of his own making. The evidence does not support the first contention, and the second does not apply to a taxpayer who disclosed to the Revenue Agent that items of receipt were not reflected in his tax returns, only to have three investigating agents thereafter conduct an examination which did not even consider the available records which presumably reflected all receipts for the years in question.

ARGUMENT.

A. Reply to Argument That Appellant Has Stipulated to Amount of Unreported Income.

The Government contends that the appellant has stipulated to facts which in and of themselves are sufficient to sustain the finding of the lower court. This argument ignores the scope of the Stipulations in question, the rationale for those Stipulations, and indeed, the workings and fallacies of the bank deposit method when establishing an understatement of income.

Through Stipulation No. 3, the Government was permitted to introduce photocopies of bank records indicating deposits in several banks, etc., without establishing foundation for the admission of the photocopies. In Stipulation No. 4, the schedules prepared by the Internal Revenue Agents, based upon the aforementioned photocopies, were admissible in evidence so as to spare Government counsel the burden of conducting extensive examination of the Agents who prepared said schedules as to the preparation of schedules and the source of each item contained therein.

In Stipulation No. 5, the parties clearly state that the defendant is merely stipulating to the receipt of funds, and the deposit of funds in specific banks while making it clear that the defendant is not in any manner categorizing such receipts or deposits as taxable income. The burden remained upon the Government to establish the fact of, and amount of defendant's alleged unreported income.

The defendant entered into the above Stipulations for the purpose of saving the Court many additional days of trial. It was not necessary for the Government to lay foundation for the admissibility of several bank accounts, including three German bank accounts, and the Revenue Agents' schedules and work sheets were also admitted into evidence without the necessity of establishing foundation. None of the Stipulations relieved the Government of its burden of establishing an understatement of *taxable income.* [Stip. 5.]

An admission of the receipt of funds in a particular bank account does not establish that said receipt constitutes taxable income. The term "receipt" is not equated to "income." This is so even if the Government establishes that the taxpayer had no taxable free sources of income. The most obvious danger encountered when using the bank deposits method is that a particular deposit might be a transfer from another bank — therefore clearly nontaxable — yet included as two receipts of income when there was in fact but one. The appellant established in his Opening Brief (p. 28) that neither investigating agent was able to state that inter-bank transfers had been eliminated. This was particularly true with respect to the transfer of funds from the German banks to the Los Angeles banks. This factor not only bears upon the amount of unreported income in this case, but raises questions as to the validity of an essential element relied upon by the Government to establish wilfulness.

The Government is apparently contending (Br. pp. 15-17) that the appellant could have shown that the Government's determination was incorrect by introducing his books and records into evidence during trial. The Government has the burden of establishing each element of the crime beyond a reasonable doubt, and its case must be established through methods which are most likely to bring the true facts before the Court. The Government may not introduce evidence of questionable reliability before the Court in hopes of establishing its case in chief; it is obligated to present that evidence which will best demonstrate the omission of taxable income during the years in question, and establish the element of wilfulness. An analysis of the cases cited by the Government demonstrates that they are not authority for its position.

In *Hoffman v. Commissioner* (8th Cir., 1962), 298 F. 2d 784, 788, cited at page 16 of Appellee's Brief, the Court was reviewing a decision of the Tax Court, and found that the defendant was required to make an affirmative showing because:

> "This is so, because Rule 32 of the Rules of Practice of the Tax Court, as well as the Supreme Court in *Welch v. Helvering,* 290 U.S. 111, 54 S. Ct. 8, 78 L. Ed. 212 and *Helvering v. Taylor,* 293 U.S. 507, 508, 55 S.Ct. 287, 79 L.Ed. 623, state that the Commissioner's determination of deficiency in tax bears a presumption of correctness, and the burden of proof is upon the petitioner to show error therein."

In *United States v. Hornstein* (7th Cir., 1949), 176 F. 2d 217, the defendant was contending that the Government had not established that there was a deficiency in tax for the years in question. The Government had apparently proved through specific omitted items that the taxpayer's gross receipts were understated. The

question facing the lower court was that of arriving at a reasonable cost of sales for those items which were sold but not reported in the defendant's books and records. The defendant apparently took the witness stand and tried to place the responsibility for the inaccuracy of his books upon his wife who was dead, and upon a cousin whose whereabouts was unknown. He offered evidence to the effect that his cost of goods sold for those items which were not reflected in gross receipts was higher than the sales price of said items. The Court did not believe his story.

We are of course here concerned with a criminal case.

> "The presumption of innocence attaches to an accused defendant at the beginning of a trial and remains with him throughout the trial of the cause. It never shifts." *Brubaker v. United States* (6th Cir., 1950), 183 F. 2d 894, 898.

The burden is upon the Government to prove each element of its case beyond a reasonable doubt, through methods which are geared to produce the most reliable evidence available.

The Fifth Amendment to the United States Constitution provides that a person need not be a witness against himself in a criminal proceeding. Title 18, Section 3481 of the United States Code provides:

> "In trial of all persons charged with the commission of offenses against the United States and in all proceedings in courts martial and courts of inquiry in any State, District, Possession or Territory, the person charged shall, at his own request, be a competent witness. *His failure to make such request shall not create any presumption against him.*" (Emphasis added.)

The Government is urging that the defendant's failure to testify and produce evidence on his behalf as to

the correct understatement of income is to cast credibility on the Government's case. This argument ignores the Government's burden of proof. If the Government's case in chief is established through improper methods, the defendant need not demonstrate that the facts allegedly proved by that method are incorrect. The Government's contention also ignores 18 U.S.C. 3481, quoted above, and the rule against comment on a defendant's failure to testify as stated in *Wilson v. United States,* 149 U.S. 60, 13 S. Ct. 765, and *Griffin v. State of California* (1965), 380 U.S. 609, 613, 85 S. Ct. 1229, 1232. The "prosecutor" is now arguing on appeal that the defendant's failure to testify and present evidence in his favor gives weight to that evidence offered by the prosecutor, when in fact such an argument is not permitted before a jury. Such an argument is clearly improper and should be ignored by this Honorable Court.

B. Reply to Argument That There Are No Conditions Precedent to Use of the Deposits Method.

In reply to the Government's contention that, "There are no conditions precedent to the utilization of alternative methods of computing taxable income," a brief introductory statement is necessary before analyzing the Government's "authority" for its position.

Is the Government in fact contending that an Internal Revenue agent may audit any taxpayer without making use of the books and records maintained by that taxpayer? Counsel can envision a situation where an investigating agent knocks on the taxpayer's door and states that he is auditing the taxpayer's return for a specific year. The agent then requests all of the taxpayer's bank records, including all deposits slips and canceled checks, and demands all invoices and other records describing assets which the taxpayer may have pur-

chased or sold within a specific period of years. He then would presumably be free to reconstruct the taxpayer's income through use of the bank deposits and net worth methods, without referring to the taxpayer's books and records for explanations of specific items, and without compulsion to contrast his tentative conclusions with the financial picture as set forth in the taxpayer's records.

The Government is contending that such an audit would be permissible, and that the results of that audit could be the basis for a criminal prosecution notwithstanding the fact that the agent had not referred to those documents which presumably most accurately reflect the taxpayer's income — his books and records.

Counsel for appellant are aware of the fact that Internal Revenue agents must be allowed a great deal of flexibility and latitude in conducting their audits so that they may match their initiative and imagination against that of the potential tax evader. However, there must be some ground rules setting minimum standards for a tax investigation. Counsel suggests that one such standard is that the investigating agent must review all records of the taxpayer which presumably reflect his financial transactions — his books and records, in the broadest sense. The agent is then free to attempt to demonstrate the inaccuracy of those records by any reasonable means, such as the bank deposits or net worth methods. The taxpayer's books and records must be recognized as the taxpayer's reflection of his income and expenses for the year; these foundation documents can be questioned and attacked, but they *must* be reviewed, analyzed, and weighed against the results of the agent's independent investigation.

The taxpayer is required under the 1954 Internal Revenue Code, Section 6001, to keep such records as

the Treasury regulations may provide. Tres. Reg. §1.6001-1 provides in part:

> "(a) IN GENERAL. Except as provided in paragraph (b) of this section, any person subject to tax under subtitle A of the Code, or any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.
>
> . . .
>
> "(e) RETENTION OF RECORDS. The books or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law."

The taxpayer is required by law to maintain books and records; investigating agents of the Internal Revenue Service are required by law to examine those books and records. The investigating agents are obviously not bound by the representations found in the books and records, but they are required to examine the records and contrast them with the results of any independent investigation demonstrating a greater taxable income than that reflected in the books.

Upon close inspection, the cases cited by the Government are not in direct opposition to the statement of law propounded by the appellant. It is first important to note that the appellant is not contending that the net worth method may not be used unless a taxpayer's books are inadequate. He is, however, contending that the Government must establish that the

taxpayer's books are *inaccurate* — it cannot conduct an audit and determine an understatement of income without reviewing and analyzing those books and records which are maintained, available, and *presumably* accurate.

The strongest statement in Appellee's Brief is that from *Davis v. Commissioner* (7th Cir., 1956), 239 F. 2d 187, found on page 19 of Appellee's Brief. What does *Davis* really say? The Court first notes (pp. 188-189), that:

> "As to the first question, it is taxpayer's contention that the net worth method may be used notwithstanding the presence of records only where evidence of concealment or falsity exists. The Supreme Court has expressly held, however, that the net worth method is not confined to situations where the taxpayer has no books or where his books are inadequate. *Holland v. United States,* 348 U.S. 121, 130-132, 75 S. Ct. 127, 99 L.Ed. 150. Taxpayer's argument is the same argument rejected by the Court in the Holland case for concealment and falsity necessarily impugn the adequacy of a taxpayer's books."

The Court then notes, at page 189:

> "*Furthermore, the Tax Court found that taxpayer's records were not adequate and this finding is well supported by the evidence.*" (Emphasis added.)

The Court's rational for stating that there are no conditions precedent to the utilization of the net worth technique is found immediately before the quotation in Appellee's Brief, and explains that statement:

> "In short, *the apparent adequacy of the taxpayer's books is the very thing that the net worth method attacks by independently demonstrating the receipt of unrecorded and unreported taxable income.*" (Emphasis added.)

The Court in *Davis* therefore found that the net worth method could be used to demonstrate the *inaccuracy* of the taxpayer's books and records. The case before this Court is one where the books and records maintained by the taxpayer were ignored throughout the investigation and trial of the case. Such was not the case in *Davis*.

The same distinctions are found in *Hoffman v. Commissioner* (3rd Cir., 1962), 298 F. 2d 784, 786, 787. In that case the Court noted:

> "The above books and records were incomplete, inadequate and in no wise covered the entire transactions involved over the years in question. The Commissioner *after inspecting the records of the petitioner* discovered that the cash expenditures for the years involved were substantially in excess of the net income reported, although he did not assert that he found any false items in the petitioner's books of account.
>
> . . .
>
> "Here, the Tax Court found that the Commissioner did everything that was possible for him to do, *in addition to examining the meager books and records of the petitioner,* he examined the tax returns of the taxpayer which were put in evidence for the years 1927 to 1947." (Emphasis added.)

In reviewing recent cases dealing with the use of the net worth method, the following statement was found in the initial sentence discussing the use of the net worth method in the case of *United States v. Fernicola* (3rd Cir., 1966), 361 F. 2d 864:

> "Since the Government was unable to obtain from the defendant books or records of his medical practice reflecting the payments of fees to him, it arrived at its calculations of the defendant's taxable income for the years involved via the 'net worth' method and prosecuted its case at the trial in accordance therewith. (Citations)"

Counsel suggest that each member of this Honorable Court who has written an opinion involving the use of the net worth method of computing taxable income has made a statement similar to that quoted above. It would be unnecessary to make such a finding if there were no conditions precedent to the use of the net worth method. Appellant has presented in his Opening Brief (pp. 11-14) the dual use of the bank deposits and net worth methods. Such methods are first used to test the taxpayer's books and records, and then may serve as evidence of unreported income. This rule was in fact restated in *Hoffman v. Commissioner of Internal Revenue, supra,* cited by appellee as authority for a contrary doctrine.

Both the Government and the appellant recognize the case of *Holland v. United States* (1954), 348 U.S. 121, 75 S. Ct. 127, as being the leading case in defining the use of the net worth method of reconstructing income. The appellee is contending that *Holland* opens the door for the Government to reconstruct a taxpayer's income without the existence of any conditions precedent. The appellant is urging that the Government must reconstruct a taxpayer's income for the purpose of contrasting the reconstructed income with that shown in the taxpayer's books and records, and then ask that the higher figure be accepted as correct.

There are many indications in the *Holland* case that the appellant's interpretation is correct. The Court first points out the well-established fact that:

> "Unlike civil actions for the recovery of deficiencies, where the determinations of the Commissioner have prima facie validity, the prosecution must always prove the criminal charge beyond a reasonable doubt." (75 S. Ct., at 130, 348 U.S. at 126.)

The Court then warns (75 S. Ct., at 132, 348 U.S., at 129):

> "While we cannot say that these pitfalls inherent in the net worth method foreclose its use, they do require the exercise of great care and restraint. The complexity of the problem is such that it cannot be met merely by the application of general rules. (Citation) Trial courts should approach these cases in the full realization that the taxpayer may be ensnarled in a system which, though difficult for the prosecution to utilize, is equally hard for the defendant to refute. Charges should be especially clear, including, in addition to the formal instructions, a summary of the nature of the net worth method, the assumptions on which it rests, and the inferences available both for and against the accused. *Appellate courts should review the cases, bearing constantly in mind the difficulties that arise when circumstantial evidence as to guilt is the chief weapon of a method that is itself only an approximation.*" (Emphasis added.)

The appellant herein is challenging the ability of the Government to proceed by use of an indirect method of determining taxable income without first thoroughly reviewing the available books and records of the taxpayer. The following language of the Supreme Court in *Holland* bears heavily in weighing this issue (75 S. Ct., at 135, 348 U.S., at 135-136):

> "While sound administration of the criminal law requires that the net worth approach — a powerful method of proving otherwise undetectible offenses — should not be denied the Government, its failure to investigate leads furnished by the taxpayer might result in serious injustice. It is, of course, not for us to prescribe investigative procedures, but

it is within the province of the courts to pass upon the sufficiency of the evidence to convict. *When the Government rests its case solely on the approximations and circumstantial inferences of a net worth computation, the cogency of its proof depends upon its effective negation of reasonable explanations by the taxpayer inconsistent with guilt. Such refutation might fail when the Government does not track down relevant leads furnished by the taxpayer* — leads reasonably susceptible of being checked, which, if true, would establish the taxpayer's innocence. *When the Government fails to show an investigation into the validity of such leads, the trial judge may consider them as true and the Government's case insufficient to go to the jury.* This should aid in forestalling unjust prosecutions, and have the practical advantage of eliminating the dilemma, especially serious in this type of case, *of the accused's being forced by the risk of an adverse verdict to come forward to substantiate leads which he had previously furnished the Government.* It is a procedure entirely consistent with the position long espoused by the Government, that its duty is not to convict but to see that justice is done." (Emphasis added.)

Can the Supreme Court, while stating that the Government has the burden of investigating all leads furnished by the taxpayer and negating all nontaxable sources of income, also be stating that the investigating agents may recompute and reconstruct the taxpayer's income without referring to, comparing, or contrasting the taxpayer's books and records with the fruit of their independent investigation? Such a holding would be entirely inconsistent with the Court's warnings of the dangers involved when establishing a tax case by use of circumstantial evidence.

In the recent case of *Lenske v. United States* (9th Cir., 1966), 18 A.F.T.R. 2d 5815, ... F. 2d ...., this Court restated the admonition of the Supreme Court in *Holland v. United States, supra*, concerning the dangers of the use of circumstantial evidence. In discussing the obligation of the investigating agents to investigate all leads, the Court stated:

> "Under the *Holland* teaching, a lead not furnished by the defendant but discovered by the Special Agent in his investigation would have at least equal status with a lead furnished by the defendant. The philosophy of Holland is that the trial of a tax fraud case by the net worth method places a defendant at a disadvantage dangerous to his liberty, and that some departure from the gamesmanship tactics of ordinary trials, even other criminal trials, is necessary to compensate for the disadvantage and make the contest more nearly equal."

The Court later noted:

> "It may be asked what harm is done, after all, by disregarding the admonitions of *Holland,* supra, putting everything into a chart showing increased net worth and having the Special Agent testify that it was prepared under his supervision and is right. There is still opportunity for cross examination and for witnesses for the defense. What is wrong, in addition to its being contrary to the law laid down by the Supreme Court, is that such a process is outrageously unfair . . . *What has happened to him is that the Government has not assumed the burden of proving, beyond a reasonable doubt, that he is guilty. It has assumed only the burden, with its unlimited resources and time, of preparing a mass of documentary evidence and charts incomprehensible to a layman, all prepared*

by the Government itself, and is saying to the taxpayer, 'Your task is to prove that all of what is contained in the charts is false, not merely that it is 96% false, but that it is all false. You do not have the time nor the resources that the government had, but that is your misfortune.'" (Emphasis added.)

C. Reply to "Quasi-Specific Items" and Wilfulness Arguments.

The appellee sets forth an interesting argument beginning on page 19 of Appellee's Brief, to the effect that this case is in reality a quasi-specific items case, rather than a bank deposits case. The appellee bases this argument on the fact that the defendant categorized deposits to his personal account at the Security First National Bank as to amount and source. These admissions, states the appellee, convert this case from a bank deposit case to a specific item case.

There is no question that the defendant attempted to identify bank deposits, at the request of the investigating agents. These deposits indicate an understatement of taxable income. The defendant advised Revenue Agent Breese that certain receipts were not reflected on his tax return, during Agent Breese's first meeting with the defendant. The defendant then claimed that these items of receipt were nontaxable; the Government and the Court disagreed.

The above argument is reasonable at first blush, but is in error when considering the appellee's arguments concerning wilfulness. The vast majority of the evidence pointed to by appellee as establishing wilfulness deals with the German bank accounts, either directly or indirectly. The German bank accounts were not reconciled by the defendant, and the Government claims that

these accounts were sources of additional income that were neither reflected on the tax return nor disclosed to the investigating agents. *Such an analysis indeed makes use of the bank deposits method.* The Agents' audit was inadequate in that it did not establish that the funds deposited in the German bank accounts were not subsequently transferred to the Los Angeles bank accounts and reported as taxable income or initially disclosed to Revenue Agent Breese. This case is in fact a bank deposits case in theory, even though it fails to prove those elements which the Government seeks to establish.

The appellant has argued in his Opening Brief that the continuation of this audit over a period encompassing several years was to appellant's detriment, and that many items relied upon by the Government in establishing wilfulness were generated through the inadequacies of the audit procedures adopted by the Agents. These inadequacies and the detriment suffered by the appellant are evident when considering the fourth item relied upon by appellee as indicating wilfulness. (Appellee's Br. p. 23.) The Government states that appellant failed to disclose that he had corresponding attorneys in connection with his claims processing business during his interview with Agent Donley on May 10, 1962. Yet, two years earlier, on May 27, 1960, during his interview with Revenue Agent Breese and Special Agent Phoebus, Dr. Roy disclosed:

> "He said that in the course of negotiating with people who had a claim against the German government, he would make a fee arrangement with them which would be expressed in writing, that the fee charged the claimants was 10 percent, 5 percent of which was kept by Dr. Roy and 5 percent which went to an attorney which he, Dr. Roy, engaged in Germany." [Tr. p. 259.]

The fact that the Government had not investigated the defendant's relationship with the corresponding attorneys, the fee agreements with said attorneys, and the forwarding of funds from Germany to the United States during the period May, 1960-May, 1962, raises serious questions as to the method and manner of the Agents' investigation. The appellant, of course, claims that he was prejudiced by the failure of the investigating agents to examine the available books and records. Such an investigation would have disclosed facts as that discussed above. The above example clearly demonstrates one specific instance in which the appellant was so prejudiced by the Agents' unwarranted use of circumstantial evidence.

This case presents an excellent example of the dangers encountered when using an indirect method of determining taxable income. In the appellant's Opening Brief (pp. 27-29) the testimony of the Internal Revenue Agent and Special Agent clearly demonstrate they were unable to establish that the funds from the Berlin bank accounts were not subsequently deposited in the Los Angeles bank accounts. This essential element of inter-bank transfers, the most important single factor to consider in a bank deposits case, was not accounted for by the Agents. Let us pause a moment to consider the significance of this fact.

The defendant admitted to Revenue Agent Breese during the initial contact that certain receipts were unreported on the tax return, as the defendant believed that they were tax-free receipts. [Tr. pp. 210-211.] The Government contends that fraudulent intent is demonstrated by the taxpayer's failure to inform the Agents of the German bank accounts at that time. However, the Agents themselves testified that they were unable to establish that the amounts deposited in the German

bank accounts were not subsequently deposited in Los Angeles bank accounts, and thereby reflected in the "Legenda" of receipts prepared by the defendant for the investigating agents. The agent's expressed intent was to reconstruct the tax return. If the question of the German bank accounts was not presented to the Court, it would be difficult for the Court to find the necessary fraudulent intent. The question of the German bank accounts, transfers from those accounts, and the alleged concealment of those accounts colored the entire trial.

If the investigating agents had reviewed and analyzed the available books and records, the entire audit and trial (should the taxpayer have been indicted) would have proceeded in a different fashion. The receipts which were not reflected in the taxpayer's income tax returns would have been ascertained through his books and records, and the sole questions before the Court would have been the taxability of the omitted receipts and the reason for the omission. The audit would have been completed in a matter of weeks, rather than a matter of years, and the taxpayer would not have been subjected to the stress and strain accompanying a lengthy Internal Revenue investigation. The procedural safeguard requested by the appellant — that the investigating agents be required to attempt to determine unreported income by first examining his books and records — would have changed the entire picture painted during the investigation, and viewed during the trial.

Conclusion.

The Government argues, in conclusion, that it should not be prevented from using a method which uncovers the maximum amount of unreported income; which, through its length and "thoroughness," establishes a wilful intent to conceal income. It is significant that the Government speaks in terms of *maximum unreported income* rather than an *accurate determination* of the taxpayer's understatement. This Court is cognizant of the dangers expressed by the Supreme Court in *Holland, supra*, and should join that Court in establishing procedural safeguards so that the Government will seek accuracy rather than maximum determinations of deficiency in future audits. The failure of the investigating agents to examine the defendant's books and records, the meaningless attempt to reconstruct appellant's income as actually reported on the return, the length of the investigation, and the failure to account for inter-bank transfers between the German banks and the Los Angeles banks clearly demonstrate that the investigation neither accurately discloses the actual understatement of income, nor is a reliable bell-weather from which to adjudge the issue of fraudulent intent.

The appellant respectfully requests that the lower court be reversed upon the grounds urged in Appellant's Opening Brief.

Respectfully submitted,

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Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

BRUCE I. HOCHMAN